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China's Excessive Savings–Investment–Debt Model Finds Itself at an Impasse

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(1) The excessive savings–investment–debt model and the current recession

The Chinese economy has an abnormal structure, with savings accounting for almost 50% of GDP. These excessive savings have driven overinvestment and excess debt, leading to the current recession. However, until the early 2010s, this high level of savings realized a marvelous economic expansion by financing huge investment and net exports. Since joining the WTO in 2001, China has seen a rapid increase in production and exports thanks to a steady influx of foreign capital and an abundant work force. The four trillion yuan in investments that the country has made since 2008 have been funded by a high savings rate, and with its growing infrastructure and rapidly expanding production China has become the world's factory. It overtook Japan to become the world's second-largest economy in 2010 and has been the world's leading exporter since 2014.

However, the government's ineffective response to the economic slowdown from 2014 to 2016 led to financial instability and a loss of about $1 trillion in foreign currency. The IMF warned the Chinese government about the rapid increase in debt caused by economic growth based on an excessive savings–investment cycle, and recommended that the government implement reforms to promote consumption and give preferential treatment to private enterprises. However, the Chinese government attempted to overcome the economic downturn by increasing investments in infrastructure, manufacturing capacities and other areas. Housing, which continues to experience rising valuations, has proven to be an extremely attractive investment, and it is not uncommon for people to own multiple homes. With these purchases people feel themselves to be rich and expand consumption. However, this has resulted in housing construction far exceeding actual demand.

The Chinese economy was hit hard by the zero-COVID policy of the 2020s, and the Xi Jinping administration's initiatives in the areas of "common prosperity", housing restrictions, and anti-espionage laws led to further economic deterioration. Regulations on home loans were also tightened, with the real estate bubble collapsing and asset deflation intensifying.

China's abnormally high savings rate continues to this day, with its total savings of 44% of GDP in 2023 being about 20% higher than that of Japan and the United States. However, investment efficiency has declined significantly, and China's overall debt continues to grow at a rate that exceeds GDP growth. The slumping real estate market led to a jump in corporate debt, with households compensating for asset deflation by building up their savings, while local governments in particular faced sizable hidden debts held by LGFVs (Local government financing vehicles) . It is worth noting that central government debt is minimal.

(2) Three key risks posed by deflation

The Chinese economy is currently in a typical deflationary state in which nominal GDP growth is lower than real GDP growth. In particular, the real estate downturn, fiscal crises at the local government level, and financial instability are seen as three key risks impeding economic recovery.

First, regarding real estate, excessive housing stock has led to falling sales and prices, effectively leading to the bankruptcy of major real estate companies and asset deflation. As the insolvent companies in many cases left constructed houses unfinished, the tenants who paid total amount of money in advance at the time of contract fall in the trap of the bank loans for unoccupied residence. Even the current occupants are obliged to pay the bank loans for the deflated assets which causes more saving in housekeeping .

In response to the downturn in the real estate industry, the government has implemented measures such as lowering the mortgage interest rate and having blue chip real estate companies complete home construction and local governments purchase homes, but these have largely proven ineffective.

Second, local governments find themselves in dire financial straits, as they face ever-widening fiscal deficits due to the expansion of infrastructure and increased expenditures for disease prevention measures, while major tax source of land revenues are substantially falling due to the real estate slump. The situation is proving chaotic, with civil servants facing salary cuts, fines mounting, and taxes being collected retroactively. A bigger challenge for local governments is the huge hidden debts they owe to LGFVs. Their only option is refinancing these through banks, but lending terms are worsening.

Financial institutions are providing both support to help the real estate industry survive and the loans that local governments need for their financial measures. Although there is a belief that major financial institutions still have ample room in their loan loss reserves, bank interest margins fell to 1.54 in June this year, which is less than the 1.8% minimum recommended margin, spreading concerns about the financial system.

(3) IMF recommendations and the Chinese government's productivity enhancement strategy

In this year's Article IV statement concerning the Chinese economy, the IMF stressed the need for more proactive central government intervention and a shift to an investment-oriented growth model. Specifically, the report stated that the central government should intervene by allowing underperforming companies in the real estate industry to leave the market, transfer tax sources to local governments, and dismantle some LGFVs and weak banks to protect the financial system. It also called for a shift to a structure in which growth is driven by consumption rather than investment.

The Chinese government's response to this has been to remain reluctant in addressing existing problems in areas such as real estate, LGFVs, and financial institutions. Rather, it has signaled its intention to achieve economic growth and stability through the evolution of the supply structure of new quality productivity, such as electric vehicles, advanced semiconductors, AI, and space-related technologies. China is sticking to its traditional approach of boosting domestic production capacity through investments funded by excess savings, with the goal of developing a path for growth through exports of new technology-related products.

At the Third Plenary Session of the 19th Central Committee held in July this year, reforms to promote Chinese-style modernization were decided to be carried out by 2029 under the twin pillars of expanding new quality productivity/becoming Science & Technology Superpower and national security/defense modernization. However, although outside the framework of China's modernization, the report mentions three key risks—the collapse of the real estate market, local government finances, and small and medium-sized financial institutions—and also takes up flood control measures, stating that the government should "guide social safety and the formation of public opinion, and respond effectively to external challenges" posed by these issues. This may reflect a strong sense of crisis. Especially flood control has been a concern for successive dynasties. The sudden collapse of levees and flooding caused by unusual weather across China this year is seen as having heightened awareness of the crisis.

(4) The impact of China's growing new quality productivity on the global market

In April of this year, U.S. Treasury Secretary Janet Yellen sounded the alarm regarding China's new quality productivity, saying that excessive investment and overproduction due to subsidies have resulted in production exceeding domestic demand, and that cheap exports by loss-making companies were disrupting global markets. China's new energy vehicle (NEV) production began in 2010 and has continued to grow thanks to technical cooperation from Tesla and support from the government in the form of subsidies, the provision of land, and loans. Over one hundred companies entered the market only to leave or go bankrupt, leaving hundreds of thousands of EVs abandoned across the country, which has created a big problem. A total of 36 million NEVs are expected to be produced per year by 2025, but as Secretary Yellen has said, along with increasing domestic competition there is the risk that exports by loss-making companies will disrupt the global market. The U.S. and Canada have announced that in the future they will be raising tariffs on Chinese NEVs to 100%. Even though the EU is scheduled to introduce a 48% increase in tariffs on Chinese-made NEVs beginning in October of this year, the growing presence of Chinese automobiles has led Volkswagen to close factories. Aiming to enter developing markets, Chinese NEV makers are setting up factories in Thailand in quick succession. Presently, EVs are struggling, and Toyota is focusing on hydrogen vehicles to maintain its competitiveness in the NEV industry. However, there is a need to remain vigilant in guarding against the future spread of Chinese NEVs and related developments in this area.

China's overproduction of industrial products that incorporate this new quality productivity and a lack of consumption within China has led to significant growth in other countries' exports to China, generating a trade surplus of about $1 trillion by 2024, which is expected to intensify trade friction with the rest of the world.

(5) The future of China's relations with the world

China has emerged as an economic and military superpower in the 21st century, and with a strategy of coercive diplomacy backed by a vast market and productive power along with its authority as a permanent member of the UN Security Council, it is gaining influence not only with Europe and the U.S. but also in the Third World. In particular, an overwhelming presence made possible through cooperation with Russia and the development assistance it provides to the Global South will allow it to directly influence the future course of international relations. However, the country's present dire domestic economic crisis is a clear sign that the days of the traditional model of successful development and economic growth based on outsized investments may very well be drawing to a close. While restricting China's economic clout and imports, the current dire domestic economic crisis will also likely lead to a strengthening of a mercantilist stance that emphasizes promoting excess production, including new quality productivity, to overseas markets. Economic difficulties could result in China becoming more closed off and security conscious. Moreover, China will likely retain a strong sense of being a great power and continue to build up its military strength, which may lead to an increased emphasis on military power in foreign affairs. Amid concerns about a Chinese invasion of Taiwan, Japan needs to monitor the movements of its neighbor even more closely.

(This is an English translation of an outline of the lecture delivered by SAKAMOTO Masahiro, Distinguished Research Fellow, the Japan Forum on International Relations, at the 200th Policy Plenary Meeting of CEAC on September 9, 2024.)